

MEMORANDUM

TO: Group Capital Calculation (E) Working Group

FROM: NAIC Staff

DATE: March 22, 2017

RE: U.S. Insurers that Do Not File RBC and Prescribed/Permitted Practices

During the 2016 Summer National Meeting, NAIC staff presented a memorandum that included possible approaches for the Working Group to consider relative to U.S. insurers that don't file RBC and/or don't use statutory accounting. The memorandum also included approaches to use for prescribed/permitted practices and "on-top GAAP adjustments." The following memorandum repeats the same information, with the exception of the on-top GAAP adjustments, which no longer seems necessary as the Working Group prefers to favor an inventory approach that uses a "bottom's up approach" as opposed to a "top-down approach."

NAIC recommends the Working Group expose the memorandum for 45 days in order to give members of the industry an opportunity to develop their thoughts around the topic and the memorandum, and provide comments on the exposure including alternative approaches.

Background Information

When considering the approach that should be taken towards both U.S. insurers that are not subject to risk-based capital (RBC) requirements and permitted practices, it may be helpful to restate one of the basic principles of an aggregated RBC group capital approach. Specifically, such an approach is based upon the fundamental view that what is most relevant are the individual insurers' and/or other regulated entities' minimum capital requirements. In other words, it is most important for the regulator to understand each of those minimum requirements and any approach that ignores such requirements is flawed, disregarding practical reality that no regulator can have its authority overridden at the entity level.

Another basic principle of an aggregation approach is recognition that no consistent valuation basis is embraced and utilized by all jurisdictions around the world; therefore the belief is that a mixed accounting model is acceptable since it reflects an appropriate measurement of the adequacy of capital for a given regulated entity, and it does not force one single valuation system upon insurers that is not cost beneficial for all of the insurers operating throughout the world.

Finally, although not a principle, as the U.S. state regulators have thought about a group capital calculation, many have recognized that its value as an analytical tool is related to understanding the capital requirements of each entity within the group and the level of capital resources allocated to meet each requirement as a means to insulate and protect the interests of policyholders of the U.S. insurance entities. NAIC staff has placed a high degree of emphasis on the analytical value as it has developed the idea of an inventory method that, for all practical purposes, represents a consolidation of two figures: minimum capital and available capital. It is worth noting and pointing out something important relative to the examples of this inventory approach. This represents a bottom-up approach to both minimum capital and available capital, with an emphasis on the former. The bottom-up approach for minimum capital is very important since, again, that represents something that cannot be overridden by another regulator, and therefore, directly impacts the calculation's minimum required capital. However, the bottom-up approach for available capital is less about developing a total available capital amount and is more about the use of that figure for analytical analysis.

EXECUTIVE OFFICE • 444 North Capitol Street NW, Suite 700 • Washington, DC 20001-1509

p | 202 471 3990 f | 816 460 7493

CENTRAL OFFICE • 1100 Walnut Street, Suite 1500 • Kansas City, MO 64106-2197

p | 816 842 3600 f | 816 783 8175

CAPITAL MARKETS & INVESTMENT ANALYSIS OFFICE • One New York Plaza, Suite 4210 • New York, NY 10004

p | 212 398 9000 f | 212 382 4207

www.naic.org

1. U.S. Non-RBC Filers For Which There Is No RBC Formula (U.S. Insurers)

Given the background, NAIC staff is of the opinion that for those U.S. insurers that do not have an RBC formula, the minimum capital per state law should be used as the basis for what is used for that insurer in the group capital calculation. However, where requirements differ between states for a particular type of non-RBC insurer, one basis for the calculation could be chosen and applied to all insurers of that particular type. NAIC staff would suggest that the requirements be further specified as follows:

Mortgage Guaranty Insurers: The minimum capital requirement shall be based upon the NAIC's requirements set forth in the *Mortgage Guaranty Insurance Model Act* (#630), specifically considering Section 3 (minimum capital and surplus requirements) and Section 12 (capital, surplus and contingency reserves equal to the minimum of 1/25th of the a total liability net of reinsurance.)

Financial Guaranty Insurers: The minimum capital requirement shall be based upon the NAIC's requirements set forth in the *Financial Guaranty Insurance Guideline* (Guideline 1626), specifically considering Section 2B (minimum capital requirements) and Section 3 (Contingency, Loss and Unearned Premium Reserves) and the other requirements of that guideline that impact capital (e.g. specific limits).

Title and Other Companies: A selected basis for minimum capital requirements derived from a review of state laws. Where there is a one-off treatment of a certain type of insurer that otherwise would file RBC (e.g., HMOs domiciled in California), the minimum capital required by their respective regulator could be considered in lieu of requiring the entity to complete an RBC blank

2. U.S. Captive Insurance Companies

Before considering this topic any further, it should be understood that what is being proposed for U.S. captive insurance companies would not apply to any holding company that does not have a traditional U.S. insurance company. However, for any U.S. insurer that has a U.S. captive insurance company in its holding company structure, it must comply with the requirements of what is proposed on the presumption that any captive used by an insurance company could be used to circumvent the policyholder protections put in place by states. The only exception that would be allowed is if the captive was being used exclusively for self-insurance or insurance provided exclusively to its own employees and/or its affiliates.

RBC: All entities that meet the limited exceptions noted above would be treated as non-insurers similar to how they would be treated in U.S. RBC. (i.e. a capital calculation of 22.5% of BACV or other applicable alternative ultimately selected by the GCCWG for non-insurers) All entities that do not meet the limited exceptions noted above would be required to complete an NAIC RBC formula using their basis of accounting, but with limited adjustments as set forth below.

Limited Accounting Adjustments: NAIC staff is of the opinion that an approach similar to the SSAP No. 97 approach should be used for determining the valuation used for U.S. captives.

SSAP No. 97 Requirements

Paragraph 9 of SSAP No. 97 provides a listing of adjustments that would be required by U.S. captive insurance companies. This specifically includes adjustments to non-admit assets pursuant to SSAP No. 6 (Uncollected balances), SSAP No. 16R (EDP Equipment), SSAP. No 19 (Furniture and Fixtures), SSAP No. 21 (Other Admitted Assets), SSAP No. 29 (Prepaid Expenses), SSAP No. 68 (Goodwill), SSAP No. 105 (Working Capital Finance Investments), deferred acquisition costs and other capitalized expenses, deferred tax assets in excess of 10% of equity, surplus notes issued by the reporting entity, and specifically identified life valuation differences.

Additional Required Adjustments

The SSAP No. 97 adjustments are primarily designed to address valuation of asset differences and do not address liability valuation differences. NAIC staff is of the opinion that in addition to the SSAP No. 97 adjustments, this calculation should also require the captive insurer's financials to utilize the valuation basis used by the direct writer of the business, thus eliminating any benefit that may have otherwise been derived by the U.S. insurer on a direct basis, and in doing so, providing a more accurate reflection.

The only exception to this requirement that the direct writers' valuation be used for the business would be a captive established for XXX/AXXX issues, on the basis that the vast majority of states have recognized a

different valuation may be reasonable on XXX/AXXX. For these captives, regulators should consider whether they would accept a different valuation that allows the captive to report reserves under principle-based reserving (PBR) (since it become operational on Jan. 1, 2017) for both new business and inforce business. Although both may be reasonable from a group capital standpoint, allowing this option for inforce business may encourage formation of additional captives than may currently exist, and therefore the Working Group may want to consider limiting only to those insurers that already had such in place prior to Jan. 1, 2017. By doing so, it would at least bring consistency in the valuation of the business prior to Actuarial Guideline XLVIII (AG 48). Regulators should consider whether allowing full retroactive recognition of XXX/AXXX reserves on a PBR-basis is consistent with the level of RBC requirements that were developed in conjunction with the level of reserves for business written prior to Jan. 1, 2017.

3. Prescribed and Permitted Practices

NAIC staff chose to address this issue in this particular memo because we believe it is closely related to the adjustments being made for U.S. captive insurers. The reason being because as one considers those adjustments, the concern that can arise is whether groups will choose to cede their U.S. business to non-U.S. based captives, knowing that statutory rules can be circumvented in this way. Although NAIC staff believes that most prescribed and permitted practices are generally not driven by an attempt to avoid statutory rules, the impact can be similar. NAIC staff was always of the opinion that the easiest way to address the issue of prescribed and permitted practices was to require an on-top adjustment (e.g. the last tab of the excel file that was distributed prior to the June 20 conference call) that totals all such adjustments of their impact on capital (as included in Note 1 of the financial statements), then detail in a separate sheet. That is the recommendation related to prescribed and permitted practices. NAIC staff is of the opinion that this should be fairly simple for companies, and should be fairly simple to develop an instruction for. Staff notes that the treatment of captives may vary across jurisdictions, with some applying the jurisdictional insurance capital formula to captives and others imposing requirements on the ceding insurer relative to cessions to the captive. Therefore, consideration may be required as to whether any scaling of foreign jurisdictional requirements should apply to captives or if other leveling of the filed approaches should be utilized.

As a starting point, NAIC staff recommends that another tab/page of the calculation be structured to allow the company to include other on-top adjustments for transactions that may circumvent the regulatory processes of individual jurisdictions through the movement of the liabilities and/or assets to another jurisdiction or entity. One of the few disadvantages of the aggregation method compared to the consolidation method is that the latter requires capital levels based upon one factor regardless where the business/assets is originated. NAIC staff is of the opinion that this risk can be mitigated by requiring the group to include a capital impact of any transaction that may circumvent the regulatory process. This is specifically meant to address the potential concern that arises relative to the above expected adjustments for U.S. captives but not the same for non-U.S. captives. NAIC staff believes the most effective way to address this may be to place some type of threshold that only requires a listing of such if it is material to the group as a whole (e.g. equal to or greater than 3% of minimum capital before such determination). Such a threshold may also be applied at the entity-level rather than the group-level, if desired. The threshold would recognize that insurers use different capital allocation techniques among non-captive insurers and many would not consider such practices as problematic unless they are material. Oftentimes, regulators utilize 3-5% as a consideration for materiality at the insurance entity level.

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